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TAGS: KTEX EFIN ETRD EAGR PGOV ELAB SENV CH
SUBJECT: YANGTZE RIVER DELTA TEXTILE MAKERS FEAR RMB APPRECIATION

REF: A. 05 SHANGHAI 798
¶B. 07 SHANGHAI 813
¶C. 07 BEIJING 7554 and previous
¶D. 07 BEIJING 7652

SHANGHAI 00000029 001.2 OF 004

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¶1. (SBU) Summary: Chinese textile manufacturers in the Yangtze River Delta (YRD) say that they face significant challenges that threaten their businesses in the coming year. Their main concern is the ongoing renminbi (RMB) appreciation that makes their exports more expensive and less competitive. New environmental standards and increased government concern about pollution mean that textile factories must implement costly mitigation plans. At the same time, Chinese textile manufacturers must cope with increased work-force costs associated with inflation and a new labor contract law. In 2008 and 2009, as much as 20 percent of the YRD's textile production capacity will be forced to close, according to a successful YRD textile company's estimate. These cuts will negatively impact the economic livelihood of the tens of millions of low-wage workers and farmers who work directly and indirectly in China's textile industry. End summary.

¶2. (SBU) Econoff met separately with three major textile manufacturers in the Yangtze River Delta (YRD), one of China's main textile producing and exporting regions. These companies included Wuxi Jinmao Ltd. General Manager Yang Nan on January 17; and, Chenfeng Group Ltd. President Yin Guoxin and Orient International Holding Company Vice President Zhong Weimin on January 18. Econoff also met with Donghua University Institute of Textile Economics Professor Gu Qingliang on January 15. Donghua University was founded in 1951 as the China Textile University and describes itself as the largest textile university in the world. Accompanying Econoff to these meetings was a two-member United States International Trade Commission delegation.

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"RMB Appreciation to Close 20 Percent of Textile Output"
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¶3. (SBU) Donghua University's Gu noted that due to fierce competition within China, China's textile industry has engaged in a race to the bottom in terms of price. As China's textile industry is dominated by companies engaged in the processing trade and exports, it is especially vulnerable to currency valuation changes.

¶4. (SBU) Each textile manufacturer with whom Econoff met said that the rate and pace of RMB appreciation is their biggest concern. (Note: The RMB has appreciated more than 14 percent against the dollar since July 2005. In the past three months the pace of RMB appreciation has picked up dramatically, and is now appreciating at an annualized rate of more than 10. End note.) Wuxi Jinmao's Yang said he closely follows RMB appreciation predictions and he expects at least 10 percent appreciation in 2008. "Frankly speaking, no textile company in China has ten percent margin left to give," he said. Yang expects that by 2009, China's textile production capacity will be reduced by 20 percent as individual factories and manufacturers close due to pressure from RMB appreciation on their bottom lines. Only those that can create new products and innovate will survive.

¶5. (SBU) Chenfeng's Yin separately agreed with Yang's gloomy outlook for Chinese textile manufacturers in 2008. "This year will be a pressure year," he said. On average, Chinese textile

exporters had profit margins that were less than 3 percent in 2007. "How can we survive a more expensive RMB?" he asked. "There will be real problems in 2008."

¶6. (SBU) Orient International's Zhong also expected that there would be a significant reduction in Chinese exports of textiles in 2008. RMB appreciation accounts for more than 50 percent of increased textile costs in China. "No one will stay in a no-profit business," he said. Chinese textile manufacturers do not take advantage of the limited financial product choices they have to help them hedge against currency unpredictability. "These types of products cost money and we Chinese love to gamble," said Zhong. "We would rather gamble that the price is lower in 90 days than pay someone else to accept that risk."

More Expensive Clothes? Blame Both Governments

¶7. (SBU) When United State retailers come to his office to bargain for a cheaper price, Wuxi Jinmao's Yang tells them that they should be negotiating with their own government in Washington, which Yang blames for driving up the exchange rate and hence cost of his textiles. Yang said that he sees a conflict between the needs of U.S. consumers for inexpensive clothes and a U.S. policy that he believes makes imported clothes more expensive for Americans.

¶8. (SBU) Chenfeng's Yin, on the other hand, blames the Chinese Government. Where ten years ago, Chinese export policies "really supported textile exporters," now, due to trade friction from Europe and the United States, "it seems that the government does not support us." In fact, the government has gone from supporting China's textile exporters to actively opposing them. Yin noted that this lack of support is apparent at every level of interaction with the government. He cited recent examples of hassles with Chinese Customs during the export process that he insists would never have happened ten years ago. Chinese RMB appreciation is another policy that is severely hurting his industry, but the Chinese Government "doesn't care."

¶9. (SBU) Orient International's Zhong separately noted that Chinese textile manufacturers had "gotten very accustomed to the 17 percent value added tax rebate on exports." With its elimination last year by the Chinese Government, textile manufacturers are really struggling.

Seeking Price Stability by Importing U.S. Cotton

¶10. (SBU) Wuxi Jinmao's Yang said that his company exported about USD 90 million worth of fabric and apparel to the United States in 2007. Since the bulk of his export earnings are priced in dollars, one way that his company has attempted to lend a measure of price stability and predictability to their input costs is to import cotton, priced in USD, from the United States. In 2007 they imported about USD 20 million worth of American cotton and anticipate they will import at least that much in 2008. This was a change from the past when they used mainly domestically-sourced cotton to avoid dealing with what Yang called cumbersome foreign exchange transaction processes requiring governmental approvals.

...And By Moving Factories Overseas

¶11. (SBU) Each of the three textile manufacturers said that they were also moving some of their factory production to lower cost countries in Asia. They specifically noted Cambodia, Vietnam, the Philippines, and Bangladesh as countries where they are expanding operations. In these cases, the Chinese parent company would assemble all of the material for a single order (fabric, thread, buttons, accessories, etc.) and package them in

a container to be shipped out of China. This order would then be assembled by garment workers in the factory abroad. Wuxi Jinmao's Yang noted that despite the lower labor cost available in countries like Vietnam and Cambodia, China's higher productivity and speed of delivery to customers means that it is still usually cheaper to produce in China.

Higher Environmental Standards = Higher Costs

¶12. (SBU) China's environmental protection requirements have become stricter and this is raising textile manufacturer's raising costs. The Central Government is increasingly concerned with the effects of pollution on China's water supply and that so much of China's water supply is no longer potable, said Chengfeng's Yin. Wuxi Jinmao's Yang said that prior to 2007, the old standard for discharged waste was 500 biochemical oxygen demand (BOD). In the wake of the 2007 Lake Tai pollution crisis (Ref B), factories in Jiangsu Province are now required to conform to a 300 BOD standard.

¶13. (SBU) Factories that do not meet this new standard can be shut down, and more than one thousand companies in the Lake Tai watershed were shut down last year, said Yang. Textile factories must be fitted with waste-water treatment equipment and more modern production and dyeing technologies to meet these higher standards. This further adds to increased unit costs for textile manufacturers.

Chinese Inflation and New Labor Law Also Increase Costs

¶14. (SBU) Chenfeng's Yin claimed that Chinese official statistics approximate that as many as 100 million Chinese are employed by the textile industry, including both up- and down-stream operations such as cotton farming and logistics. Most of these employees are from the less-educated and more marginalized peasant class and migrant workers. China's increasing inflation rate (Ref C) hits these most vulnerable populations the hardest since so much of their income is used to pay for food and clothing, said Yin. In the face of inflation, textile companies must increase wages for their employees and pay more for manufacturing inputs such as cotton and energy.

¶15. (SBU) Yin also noted that his own company chose to lay off 600 workers as a result of the new Labor Contract Law took effect on January 1, 2008 (Ref D). Due to the provisions of this law, his company would have been forced to make these 600 employees "permanent" employees since they had either worked at the company for ten years or had signed more than two contracts with the company. Since a company's ability to dismiss permanent employees has become much more difficult under the Labor Contract Law, Chenfeng and other textile manufacturers felt compelled to release some of their longer-serving, more experienced workforce in order to contain future costs. Even so, such workforce manipulation is not cost-free; Yin said that training new employees incurs costs and newly trained employees often are not as productive as the employees they have replaced. (Comment: Press reports have also noted or alleged similar jettisoning of long-term employees in other types of Chinese industries in the run-up to the Labor Contract Law's entry into force on January 1. End comment.)

Seeking Lower Costs By Moving West and North

¶16. (SBU) Rising costs and rising wages in the YRD is leading some textile manufacturers to move factories westward. Wuxi Jinmao's Yang said that ten years ago all of his factories were

in Wuxi, a city not far from Shanghai in the lower part of Jiangsu Province. Five years ago Wuxi Jinmao opened factories in a poorer part of northern Jiangsu. Now they are opening factories in neighboring (and even poorer) Anhui Province. However, due to the relative complexity of assembling garments -- a shirt has as many as 30 separate component parts -- Yang believes that management needs to be close by to insure high standards and quality control. For his company, this means the factory must be within three hours drive of Wuxi. Given the region's improving highway network, this geographic circle is widening, he added.

¶17. (SBU) Another important factor in textile manufacturing is that it requires a relatively skilled labor force. As migrant workers, who are often recruited from poorer geographic areas (first northern Jiangsu Province and now Anhui Province) learn the skills and return home, the textile company can then "follow the workers." This is what Wuxi Jinmao did in establishing some of its newer plants.

¶18. (SBU) However, Chenfeng's Yin noted that moving textile factories to the less-developed interior of China does not make much sense since benefits from lower labor and production costs are offset by increased logistics and transportation costs and reduced proximity to markets and company management.

Comment: What is the Opposite of Subsidy?

¶19. (SBU) Given the competitive nature of the global textile trade, it is not surprising that textile manufacturers in China are expressing concern about how hard it is to stay profitable. The challenges that textile manufacturers in the Yangtze River Delta currently face are exacerbated by the fact that much of the industry developed during a time of direct and indirect government support in the form of rebates of value-added taxes, multi-year corporate tax holidays and other investment inducements as localities sought new job creators, as well as a fixed, non-market based exchange-rate. As Chinese textile production soared and competition drove profit margins down, the profitability of many textile companies became increasingly dependent upon VAT rebates and export competitiveness facilitated by the fixed exchange rate. Mounting labor and environmental protection costs, higher RMB appreciation, and the removal of structural supports have had the effect of a "negative subsidy." Stress in the textile industry will be transmitted directly to the millions of migrant workers and farmers who are employed by it. Whether due to increased RMB appreciation, increased labor and input costs, or long-overdue attention to environmental protection, increased production costs for textiles in the Yangtze River Delta will likely be passed on to U.S. consumers clothes imported from China.
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